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August 12, 1997

TO: All County Superintendents of Schools,
District Superintendents of Schools,
Community College Districts, and
Other Employing Agencies

FROM: EXECUTIVE OFFICE

SUBJECT: Administrative Directive 97-9 DB (CORRECTED COPY)
Creditable Compensation and Class of Employees
(Supersedes AD 93-6)

PURPOSE

To inform employers that Assembly Bill (AB) 3032 (Chapter 1165, Statutes of 1996) repealed and added the definition of "class of employees" (Section 22112.5), repealed the definition of "compensation" and "salary" (Section 22114), and added a definition of "creditable compensation" (Section 22119.2) to the Teachers' Retirement Law (TRL - Part 13 of Division 1 of the California Education Code). The amendment to Section 22112.5 and the provisions of Section 22119.2 became operative on July 1, 1996.

SCOPE

This Directive is applicable to all school districts, community college districts, county superintendents of schools and other employing agencies that retain persons to perform creditable service under the State Teachers' Retirement System (STRS) Defined Benefit (DB) Plan.

DISCUSSION

AB 3032 was passed by the Legislature and signed into law by the Governor as Chapter 1165, Statutes of 1996. This legislation repealed Section 22114 of Part 13 of Division 1 of the Education Code that provided a definition of "compensation" and "salary," and added Section 22119.2 to provide a definition of "creditable compensation." AB-3032 also defined "class of employees" in Section 22112.5 to (1) permit a class of employees to consist of one person under specified circumstances, and (2) authorize the Teachers' Retirement Board to make a final determination on whether or not a group or an individual constitutes a class of employees.

With the enactment of AB-3032, the Education Code provides a definition of "creditable compensation" that specifies the circumstances under which compensation paid to a member of the STRS DB Plan is creditable or not creditable. The definition is applicable for the purposes of determining contributions to the plan and benefits payable from the plan.

Reporting compensation in compliance with Sections 22112.5 and 22119.2 ensures consistent treatment of compensation for all members of the DB Plan throughout their careers. When contributions are accurately collected from active member compensation for performance of creditable service, the System is able to provide equitable benefits in accordance with the STRS DB Plan design and maintain the fiscal integrity of the Teachers' Retirement Fund.

A. Creditable Compensation

"Creditable compensation," as defined by Section 22119.2 of the Education Code, is used to determine contributions to, as well as benefits payable from, the DB Plan. Creditable compensation under the DB Plan means salary and other remuneration in cash by an employer to a member for "creditable service" pursuant to Section 22119.5. Creditable compensation includes the following types of payments:

1. Money paid in accordance with a salary schedule based on years of training and years of experience as specified in Section 45028 for creditable service¹ performed up to and including the full-time equivalent² for the position in which the service is performed.

Compensation paid in accordance with a salary schedule based on any factor(s) other than years of training and experience, and salary based on individual employee performance is not creditable.

2. For members not paid according to a salary schedule, money paid for creditable service performed up to and including the full-time equivalent for the position in which the service is performed.
3. Money paid for the member's absence from performance of creditable service as approved by the employer, except as provided in paragraph (7) of subdivision (b) of Section 22119.2.

For example, compensation paid to the member for employer-approved use of accrued sick leave is creditable. Payments by the employer to the member for accrued, but unused, time are not creditable.

¹ Refer to Administrative Directive 97-4, "Creditable Service," for a discussion of creditable service.

² Refer to Administrative Directive 96-02, "Minimum Standards for Full-Time Service and Compensation," for a discussion of full-time equivalent.

4. Member contributions picked up by an employer pursuant to Section 22903 or 22904 of the Education Code.
5. Amounts deducted by an employer from the member's salary, including deductions for participation in a deferred compensation plan; deductions for the purchase of annuity contracts, tax-deferred retirement plans, or other insurance programs; and deductions for participation in a plan that meets the requirements of Section 125, 401(k), or 403(b) of Title 26 of the United States Code.

There has been some confusion regarding the creditability of employee contributions to a cafeteria plan pursuant to IRC Section 125. As long as the employee contributions are to a valid IRC Section 125 plan and are deducted from the member's salary, the contributions are included in the creditable compensation as determined pursuant to paragraph number 1 or 2 above. The employer may wish to seek counsel to ensure that the cafeteria plan meets all of the applicable provisions of IRC Section 125 and any related Internal Revenue Service regulations.

6. Money paid by an employer in addition to salary pursuant to paragraph (1) or (2) of Section 22119.2 if paid to all employees in a class in the same dollar amount, the same percentage of salary, or the same percentage of the amount being distributed.

From time-to-time an employer may have additional funds available to disburse to employees in the form of off-salary schedule payments. Whether or not such funds paid to a member are creditable compensation depends on the manner in which the funds are paid. Additional compensation is creditable and must be reported to STRS as creditable compensation if everyone in the class of employees is paid on a systematic basis such as the same dollar amount, the same percentage of salary, or the same percentage of the total amount being distributed. The most common payment of this type is the equitable disbursement of the employer's proceeds from the California State Lottery.

Off-salary schedule payments that are paid on a selective basis or in an inconsistent manner are not creditable compensation. The following examples illustrate non-creditable off-salary schedule payments:

- * Money paid to some employees in a class in addition to salary, not for performance of creditable service but because the employees meet selected criteria such as having reached a particular age, having been employed with the employer for a certain period of time, or having agreed to retire;
- * Money paid to an employee as an incentive to retire;
- * Money paid by the employer as a performance bonus to one or more individuals in a class of employees, but not to everyone in that class of employees;

* Money that is not distributed in the same manner (e.g., the same dollar amount, the same percentage of salary, or the same percentage of the amount being distributed) to all persons in the class of employees.

Written authorization from STRS must be obtained prior to reporting off-salary schedule payments as creditable compensation regardless of whether the payments will be reported as lump-sums or periodic payments.

7. Any other payments the Board determines to be "creditable compensation."

For instance, the Board may consider a stipend for extra responsibility to be creditable compensation, depending on the circumstances under which the stipend is paid. If there is agreement between the employer and employees for payment of a stipend and employees are granted release time from their usual duties so they can instead accomplish the extra responsibility, the stipend paid for that extra responsibility is creditable compensation.

A stipend paid to a teacher for performing additional duties as Department Chairperson could be creditable compensation if the employee were released from teaching a class in order to perform the duties. Also, a stipend paid for extra responsibility that is part of the employee's normal duties would be creditable compensation (e.g., a stipend paid to an employee who has additional skill as a bilingual teacher).

B. Non-creditable Compensation

Creditable compensation does not include any of the following types of payments:

1. Money paid for service performed in excess of the full-time equivalent for the position.
2. Money paid for overtime or summer school service, or money paid for the aggregate service performed as a member of the DB Plan in excess of one year of service credit for any one school year.

When a member is employed in more than one position for one or more employers, the member's compensation for the aggregate service in excess of that required to receive one year (1.000) of service credit in any one school year is compensation for overtime. Compensation for overtime service is not creditable compensation under the DB Plan. However, the member's compensation for overtime must be reported to STRS as non-creditable compensation without remittance of contributions on the employer's Monthly Report of Contributions (F-496). This permits STRS to monitor changes in the member's employment and to facilitate adjustments in reporting if it is subsequently determined that the service for which the compensation was received was not overtime.

If an employer offers the STRS Cash Balance (CB) Plan, the employer may allow employees to participate in the CB Plan for creditable service that is not subject to coverage under the DB Plan pursuant to the provisions of Section 26402.

3. Money paid for service that is not creditable service pursuant to Section 22119.5.

Except as otherwise provided in Section 22712.5, non-creditable service would include (but would not be limited to) instructional service in community service, fee-split, and not-for-credit classes.

4. Money paid by an employer in addition to salary paid under paragraph (1) or (2) of subdivision (a) of Section 22119.2, if not paid to all employees in a class in the same dollar amount, the same percentage of salary, or the same percentage of the amount being distributed.

Stipends for extra responsibilities when the employee is not granted release time from his or her usual duties, and stipends for increased class size are not creditable compensation.

5. Fringe benefits provided by an employer.

STRS has developed a working definition of fringe benefits as follows:

“Fringe benefits” means non-cash compensation to or on behalf of the employee as a result of direct payment from the employer to a third party, any cash residual from money allocated for the purchase of fringe benefits by the employer, and remuneration in cash upon which the employer places requirements for expenditure.

6. Job-related expenses paid or reimbursed by an employer.

STRS has developed a working definition of job-related expenses as follows:

“Job-related expenses” are costs incurred in the course of employment for which remuneration is advanced or reimbursed by the employer.

Creditable compensation does not include (1) money paid to the employee in anticipation that job-related expenses will be incurred; (2) money paid to the employee as reimbursement after job-related expenses are incurred; and (3) job-related expenses paid by the employer directly to a third party on the employee's behalf. The types of payments described in this paragraph are not payments for creditable service and are not creditable compensation.

7. Money paid for unused accumulated leave.

This excludes from creditable compensation money the employee is paid for accumulated but unused sick leave or vacation time. An example of this situation would be money paid for leave or other time that the employer does not permit the employee to carry over to a subsequent school year, or that remains upon termination of the employment contract.

8. Compensatory damages or money paid to a member in excess of creditable compensation as a compromise settlement or severance pay.
9. Annuity contracts, tax-deferred retirement programs or other insurance programs, including, but not limited to, plans that meet the requirements of Section 125, 401(k), or 403(b) of Title 26 of the United States Code that are purchased by an employer for the member.

An example would be the employer providing these benefits to an employee through direct payment to a third-party vendor. The cost of the benefits would not be deducted from the member's salary and would not be creditable compensation.

10. Any payments determined by the Board to have been made by an employer for the principal purpose of enhancing a member's benefits under the plan.
11. Any other payments the Board determines not to be "creditable compensation."

C. Class of Employees

AB-3032 amended the definition of "class of employees" in Section 22112.5 of the Education Code effective with the section's operative date of July 1, 1996 to read:

Section 22112.5. (a) "Class of employees" means a number of employees considered as a group because they are employed to perform similar duties, are employed in the same type of program, or share other similarities related to the nature of the work being performed.

(b) A class of employees may consist of one person if no other person employed by the employer performs similar duties, is employed in the same type of program, or shares other similarities related to the nature of the work being performed and that same class is in common use among other employers.

(c) The board shall have the right to override the determination by an employer as to whether or not a group or an individual constitutes a "class of employees."

AB-3032 amended the definition of "class of employees" to allow for a class of employees that consists of only one person under certain specified conditions. Classroom teachers in general would be in the same class of employees. However the employer may, for example, consider Title I teachers to be a separate class because all Title I teachers are in a separate program or perform similar duties that are distinct from those of other classroom teachers. While it is the employer's responsibility to establish classes of employees appropriate for the service performed for that employer, the definition of "class of employees" provides the Teachers' Retirement Board with authority to override the employer's determination of a class solely for the purpose of determining creditable compensation. This authority is provided to the Board to avoid the artificial establishment of a "class" for the purpose of manipulating compensation.

For a payment to be creditable compensation, it must be paid consistently to the entire class of employees. If compensation that is restructured results in a salary increase, that salary increase will only be creditable compensation if the restructure was implemented in a consistent manner for the entire class of employees. Please refer to the following section for additional discussion on the restructure of compensation.

The determination of full-time equivalent (FTE) also must be consistent for the class of employees. By maintaining appropriate classes of employees, ensuring the consistent determination of FTE, and consistent treatment of compensation and collection of contributions within each class, employers facilitate equitable benefit calculations by the System.

D. Restructure of Compensation

Restructure of compensation has historically been limited to negotiation of individual contracts or groups of individuals within a class who met an age or service threshold. Recently, however, restructures have been implemented for an entire class of employees who are covered by the same collective bargaining agreement.

The System's consulting actuary has advised that an increase in creditable compensation resulting from a restructure of compensation to include as creditable compensation an amount formerly used to provide fringe benefits or job-related expenses would not have an adverse impact on the integrity of the Teachers' Retirement Fund under the following conditions:

- The restructure is implemented for an entire class of employees;
- The class of employees for whom the restructure is implemented is not age or service biased; that is, the group consists of individuals who share job similarities and persons are included in the group without regard to age or length of service on an individual basis;
- The restructure is not done for the principal purpose of enhancing benefits payable from the DB Plan; and
- The restructure is intended to be a permanent change in the employer's business practice.

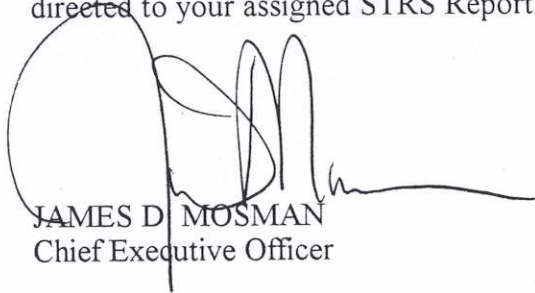
While the conditions listed above must be met in order to restructure a previously paid fringe benefit or job-related expense to creditable compensation, the conditions are not all-inclusive of the criteria that STRS may apply when determining the validity of a restructure for creditable compensation purposes. The System retains the right to review a restructure of compensation along with other employer practices through the usual audit process, and to determine whether or not a particular payment to a member is creditable compensation.

An increase in the salary of a member who is the only employee in a class pursuant to subdivision (b) of Section 22112.5 that arises out of an employer's restructuring of compensation during the member's final compensation period will be presumed to have been granted for the principal purpose of enhancing benefits under the plan and will not be creditable compensation. If the Board determines sufficient evidence is provided to the System to rebut this presumption, the increase in salary may be deemed creditable compensation.

Attachments 2, 3, and 4 to this administrative directive provide guidelines STRS will use to determine whether or not a particular payment from the employer to the employee is creditable compensation. The guidelines are representative of the criteria STRS will consider in determining creditable compensation and will continue to evolve as STRS gains additional information regarding employer compensation practices.

ACTION

All employers must report compensation for creditable service on the Monthly Report of Retirement Contributions (F-496) in accordance with the Teachers' Retirement Law and this Directive. Employer questions regarding this Directive should be directed to the Reporting Section of the STRS Membership Division. Any concerns with implementing the reporting requirements should be directed to your assigned STRS Reporting Section Analyst or Supervisor.



JAMES D. MOSMAN
Chief Executive Officer

Attachments (4)

LIST OF STATUTORY CITATIONS

The information provided in this Administrative Directive is based on the following statutory provisions:

CALIFORNIA EDUCATION CODE

Section 22112.5
Section 22119.2
Section 22119.5
Section 22138.5
Section 22138.6
Section 22151
Section 22712.5
Section 22903
Section 22904
Section 26402
Section 45028

CALIFORNIA REVENUE & TAXATION CODE

Section 17501

UNITED STATES CODE

Section 125
Section 401(k)
Section 403(b)
Section 414(h)(2)

STATE TEACHERS' RETIREMENT SYSTEM

DEFINED BENEFIT PLAN

DETERMINING SALARY

Effective July 1, 1996

The following list of questions may be used as *guidelines* to assist in determining whether remuneration in cash is salary or another form of compensation. The list is not intended to be all-inclusive of the relevant criteria, but rather is intended to indicate the type of logic that will be considered by STRS when making a determination regarding a particular form of compensation.

In order for the amount in question to be salary, the answer to all of the following questions must be "yes."

1. Is the amount in question payable in cash by the employer to the member?
2. Is the amount in question payable by the employer to the member for creditable service as defined in Education Code Section 22119.5?
3. Does the amount in question appear on the salary schedule under which the member is paid; or is it included as salary in the member's contract of employment (whichever is applicable)?
4. Is the amount in question reported to the Internal Revenue Service as taxable income?
5. For employees hired on or after April 1, 1986, is the amount in question subject to Medicare tax withholding?
6. Is the amount in question paid to the member through the employer's payroll system?

Typically, if the amount in question is salary, it is also included in the base amount upon which future salary increases will be determined.

The amount in question is not salary under any of the following circumstances:

- The amount in question is paid by the employer to a third party to provide fringe benefits on behalf of the member.
- The amount in question is an advance payment or reimbursement by the employer to the member for job-related expenses.
- The amount in question is paid by the employer to the member on a business warrant.

STATE TEACHERS' RETIREMENT SYSTEM

DEFINED BENEFIT PLAN

DETERMINING CREDITABLE COMPENSATION
FOR REMUNERATION IN CASH THAT IS NOT "SALARY"

Effective July 1, 1996

The following list of questions may be used as *guidelines* to assist in determining whether remuneration in cash that is not salary is otherwise creditable compensation as defined in Education Code Section 22119.2. This list is not intended to be all-inclusive of the relevant criteria, but rather is intended to indicate the type of logic that will be considered by STRS when making a determination regarding a particular form of compensation.

In order for the amount in question to be creditable compensation, the answer to all of the following questions must be "yes."

1. Is the amount in question payable in cash by the employer to the member?
2. Is the amount in question payable by the employer to the member for creditable service as defined in Education Code Section 22119.5?
3. Is the amount in question reported to the Internal Revenue Service as taxable income?
4. For employees hired on or after April 1, 1986, is the amount in question subject to Medicare tax withholding?
5. Is the amount in question payable to an entire class of employees on the same basis (e.g., the same dollar amount, same percentage of salary, or same percentage of the amount to be distributed)?
6. Is the amount in question paid to the member through the employer's payroll system?

The amount in question is not creditable compensation under any of the following circumstances:

- The amount in question is paid by the employer to a third party to provide fringe benefits on behalf of the member.
- The amount in question is an advance payment or reimbursement by the employer to the member for job-related expenses.
- The amount in question is paid for the principal purpose of enhancing a member's retirement or other benefits under the STRS Defined Benefit Plan.
- The amount in question is excluded from creditable compensation under the provisions of Section 22119.2, or any other section of the Education Code.

STATE TEACHERS' RETIREMENT SYSTEM
DEFINED BENEFIT PLAN

DETERMINING CREDITABLE COMPENSATION
SUBSEQUENT TO A RESTRUCTURE OF COMPENSATION
Effective July 1, 1996

The following list of questions may be used as *guidelines* to assist in determining whether an amount the employer formerly used to provide fringe benefits or job-related expenses for the employee has been *restructured* to creditable compensation as defined in Education Code Section 22119.2. This list is not intended to be all-inclusive of the relevant criteria, but rather is intended to indicate the factors that will be considered by STRS when determining whether or not a particular amount has actually been restructured to creditable compensation.

In order for the amount in question to be restructured to creditable compensation, the answer to all of the following questions must be "yes."

1. Is the group of people for whom the restructure will be implemented a valid "class of employees" as defined in Education Code Section 22112.5?
2. Will the restructure of compensation be implemented for the entire class of employees on a consistent basis?
3. Does the restructure of compensation represent a change in the employer's business practices; and, as such, is it intended that the restructure be implemented for an indefinite period of time?
4. Will the amount of restructured compensation be payable in cash by the employer to the member?
5. Will the amount of restructured compensation be payable by the employer to the member for creditable service as defined in Education Code Section 22119.5?
6. Will the amount of restructured compensation be reported to the Internal Revenue Service as taxable income?
7. For employees hired on or after April 1, 1986, will the amount of restructured compensation be subject to Medicare tax withholding?
8. Will the amount of restructured compensation be paid to the member through the employer's payroll system?

DETERMINING CREDITABLE COMPENSATION
SUBSEQUENT TO A RESTRUCTURE OF COMPENSATION
Effective July 1, 1996

Typically, if the amount in question is restructured to creditable compensation, the answer to the following questions would be "yes."

1. Will the amount of restructured compensation be added to the salary schedule or included as salary in the member's employment contract (whichever is applicable)?
2. Will the amount of restructured compensation be included in the base amount upon which future salary increases will be determined?

The amount of restructured compensation is not creditable compensation under any of the following circumstances:

- The principal purpose for the restructure of compensation is to enhance retirement or other benefits payable under the Defined Benefit Plan.
- The amount of restructured compensation will be paid by the employer to a third party to provide fringe benefits or job-related expenses on behalf of the member.
- The employer will establish requirements for the expenditure of the amount in question to which the member must adhere. For example, the employer might require the member to spend the amount of restructured compensation on the purchase of fringe benefits.
- The member will be required to account for expenditure of the amount of restructured compensation. For example, the employer might require the member to document job-related expenses in order to be entitled to the amount in question.
- The amount in question is excluded from creditable compensation under the provisions of Section 22119.2 or any other section of the Education Code.